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181757Z Mar 05

UNCLAS SECTION 01 OF 03 MADRID 001088

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TREASURY PASS TRACI PHILLIPS  
STATE PASS FEDERAL RESERVE AND DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [AMGT](#) [SP](#)

SUBJECT: SPAIN'S BOOMING HOUSING MARKET AND THE UNCERTAIN  
FUTURE

REF: 2004 STATE 00604

**1. SUMMARY:** The Spanish housing market in 2004 and the first trimester of 2005 can be characterized by record growth, easy credit, and poor rentability. In recent years, tremendous demand for housing, coupled with insufficient supply has resulted in rising prices and unprecedented construction. Despite similarly high demand and lower costs for rental housing, inadequate legal protection for landlords has limited growth in the rental market. The GOS believes that a more accessible rental market would help address the public's concern regarding affordable housing. Although the Spanish government recognizes the shortcomings of the rental market, it has done little to liberalize the rental code. In recent years, increases in home prices have outpaced salary growth and inflation. This fact combined with 2% interest rates and easy credit has resulted in record levels of mortgage indebtedness among Spaniards. Most public officials, private analysts and press sources agree that the housing market is overvalued and predict an eventual and gradual correction in the medium term. END SUMMARY.

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Growing Demand, Price Increases and the Construction Boom  
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**2.** The primary cause of high housing costs and booming construction rates has been the growing demand for homes. According to Juan Iranzo (Director General of the Institute of Economic Studies in Madrid), sustainable increases in demand can be attributed to both demographic and financial factors. Iranzo listed four specific demographic reasons for the high demand: the creation of five million new jobs in the past ten years; foreign real estate investment (which has more than doubled since the introduction of the euro); record levels of immigration; and increasing frequency of separation and divorce. On the financial front, Iranzo highlighted two primary causes: record-low interest rates resulting from fierce inter-bank competition and extended mortgage periods.

**3.** The cost of housing in Spain has grown exponentially in recent years. Since 1998, the average cost to buy has increased by 150%, compared to salary growth of 32.7%. Spanish housing prices in 2004 rose by 17.4%; only Hong Kong and South Africa registered higher increases. Spain now possesses one of the highest "home price to wage" ratios in the EU and Spaniards are spending more than ever on their mortgages. However, this fact is somewhat mitigated by the increasing prevalence of dual income-earning households. Working women have played a large role in ensuring the relative affordability of housing in the current Spanish market.

**4.** As a result of the high demand for housing, construction of new homes has risen substantially. In the last ten years, annual construction rates have increased by an average of 123.5%. In 2004, 756,000 new homes were built, 11.2% more than the 675,000 constructed in 2003. In the past year alone, more residences were built in Spain than in France (340,000), Italy (200,000), and Germany (150,000) combined. Since the year 2000, Spain has constructed more than half a million new homes annually; a figure which accounts for over 40% of all new-home construction in the EU and 6% of Spain's GDP. Last year, 18 homes were constructed for every 1000 Spaniards.

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Low Interest Rates, Easy Credit and Record Debt  
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**5.** Despite significant increases in real estate prices, Spaniards continue to buy. Low interest rates (around 2%) and easily accessible credit have resulted in record mortgage lending. Additionally, extended loan periods have made mortgage payments more affordable, especially for young adults and immigrants. According to the Spanish Mortgage Association, the volume of mortgage lending increased by a factor of 4.5 between 1996 and 2004. The same source states that from 1990 to 2004 the average loan period increased from

12 to 25 years.

16. Easier credit has translated into greater debt among Spaniards. A 24.1% increase in mortgage lending during 2004 brought the national volume of mortgage debt to 581 billion euros (\$777 billion), or 73.1% of the Spanish GDP. Divided among the 43.1 million residents of Spain, this collective debt averages 13,500 euros (\$18,048) per person.

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The Rental Market  
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17. According to Juan Justo Tíñaut Elorza (Subdirector General for Real Estate Policy of the Spanish Ministry of Housing), only 9% of all Spaniards rent homes, compared to the European average of 32%. The low supply of rentable housing in Spain is primarily attributed to insufficient legal protection for landlords. Bank of Spain economists Llanos Matea and Jorge Martínez told econoff that it can often take up to two years for a landlord to evict a delinquent tenant. They added that stringent rent control policies and freezes have also dissuaded potential landlords from renting their property. Tíñaut commented that Spanish law requires landlords to offer tenants minimum five-year housing contracts and rents that cannot be increased by more than inflation. Although tenants are permitted to opt out of the contract after one year, landlords are bound for the duration. Consequently, many homeowners have and prefer to leave their property vacant rather than rent. The fact that so many potential rental properties remain empty in the face of such great demand is a unique phenomena of the Spanish housing market. It is estimated that up to 3.1 million properties in Spain remain vacant.

18. Demand for rental housing far exceeds available supply, especially among Spain's growing immigrant population. In fact, only one of every five people who wants to rent is able to do so. Yet despite this high demand, rental prices have not undergone the same increases as purchase prices. According to the National Statistics Institute, rental costs increased by 4.24% in 2002, 4.26% in 2003 and 4.1% in 2004, only slightly more than inflation. In the last three years, the cost of rental property has increased by 15.1%, whereas purchase prices increased by over 17% in 2004 alone. The average Spanish homebuyer devotes 43.7% of his annual income to his residence, while the average renter only devotes 27.7%. (These figures jump to 61.6% and 36.5% respectively in Madrid's hot housing market).

19. Solving the problem of rising housing costs for young people and moderate income earners was one of the Socialist government's main campaign promises. In early 2005 the Socialists began to follow through on this promise by establishing the Public Rental Agency to stimulate the rental market. The Agency has two main functions: to offer potential landlords legal safeguards and financial incentives to rent their property; and to develop inexpensive rental housing for low income groups. In most advanced economies, the rental market is important because it acts as a balance on home prices. When housing costs start to rise, rental options become more attractive and demand to purchase homes falls. A stronger rental market in Spain would help to moderate growth (and decline) in housing prices. Tíñaut seemed to infer that the GOS is unwilling to liberalize the rental code to facilitate renting. Instead the government has put its faith in intermediary agencies that work to increase the availability of rental property without expanding the rights of landlords. He remarked that intraparty political compromise on rental (and housing) issues is difficult to achieve.

110. As Tíñaut explained, much of Spanish housing and rental policy is determined by the Autonomous Communities and municipalities. This creates a patchwork-national policy which inhibits flexibility, especially in the rental market. Although zoning laws are oftentimes a part of the patchwork confusion, Tíñaut said that zoning should not be considered one of the main causes of the recent price increases.

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Overvaluation and the Inevitable Correction  
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11. Most economists agree that the Spanish property market is overvalued by approximately 20%. Although a small minority of analysts predict continued annual growth of over 15%, and an even smaller group fears a sudden and catastrophic "bubble bursting," most experts anticipate a gradual and progressive correction in the market. General consensus holds that growth in the housing market will decelerate during 2005, registering around 8% to 10%. In 2006, many analysts, including economists at BBVA (Spain's second largest bank), predict that growth in the property market will fall into line with inflation. In other words, by the end of next year, nominal growth in the housing sector is expected to drop to

around 3% while real growth is expected to disappear. Ministry of Housing Subdirector General Tinaut seemed to cautiously agree with the BBVA's prediction.

¶12. An increase in interest rates over the short and medium term could have a dramatic effect on the housing market. According to the Spanish Mortgage association, 99.2% of all home loans have variable interest rates, leaving homeowners vulnerable to even slight rate hikes. A moderate rise in interest rates, from the current 2% levels to 4% or 4.5% would increase monthly mortgage payments and decrease consumer purchasing power. Reduced demand for housing and a slowdown in the construction sector could result in a consumption effect trickling through the economy. Alternatively, interest rate hikes would probably not increase rental costs.

¶13. Comment: After years of rising housing costs and record construction growth, many analysts believe that a gradual correction is about to begin. Spaniards without homes eagerly await a fall in housing prices while others, whose wealth is tied up in home equity, will be hard hit by a decline in growth. In the past several years, booming home construction, which accounts for 6% of Spanish GDP, has been a linchpin of Spain's economic growth. Reductions in construction volume resulting from falling housing demand will weaken the economy. The current Socialist government has focused on improving the rental market in order to follow through on campaign promises to increase the availability and affordability of housing. Despite this fact, the GOS refuses to enact landlord-friendly legislation. The government seems to believe that public rental agencies represent the best mechanism to increase rental availability without infringing on tenants' rights.

¶14. The key determinant in the housing market is the variable interest rate mortgages most Spaniards hold. Even a slight rate increase by the European Central Bank would result in falling demand, lower home prices, reduced construction and possibly, a general economic slowdown. The political implications of a recessed housing market are also significant. If the economy begins to slow in 2006, it is widely speculated that the Socialist PSOE government will call early elections.

MANZANARES